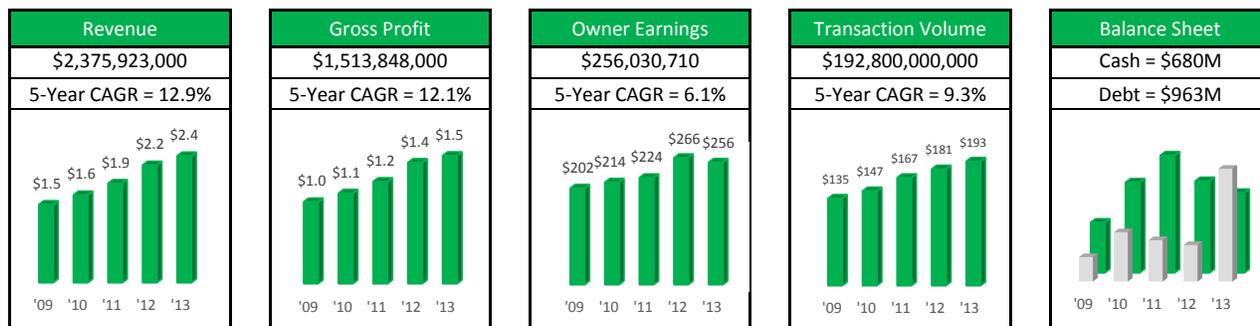




Global Payments Inc.  
April 17, 2013

## General Overview

Global Payments (GPN) is headquartered in Atlanta, Georgia and is a leading provider of payment processing services. The company processes roughly \$200 billion dollars in transactions for more one million merchants worldwide. The company holds the number #1, #2, or #3 position in terms of market share in 16 countries around the world.



## Purchase Logic

GPN is a global leader in payment processing and has demonstrated extremely predictable and healthy growth for the last 10 years. Since 2003 the company has grown net income by more than 400% with year-over-year increases every year...except one.

In early March of 2012 the company had a security breach that cost the firm more than \$120 million to remedy – a very high percentage of their income. The security breach was self-reported, which is very important for the integrity of the business, and actions were taken to correct the issue. The majority of the costs associated with the breach were one time in nature, but the company increased annual spending on security solutions for card information. The annual increase in expenses and remediation for the breach caused a slight decline in income for 2013 when compared to 2012. We believe this decline is temporary in nature and the outstanding growth will resume – even with the higher security expenses.

In 2013 the company earned \$256 million despite the security breach and large amortization expense of acquired customer relationships. When these two items are added back the potential earning power of GPN is significantly higher than the reported figure for 2013. The short-term headwinds allowed us to purchase our stake in GPN for approximately 11x forward looking earnings – an outstanding price for such a predictable and stable enterprise.

## Key Metrics

The key metrics for Global Payments are Revenue, Gross Profit, Owner Earnings, and Transaction Volume. These metrics are largely driven by the strength of the company’s sales force and the retention rate for contracts in force. Each metric is described in greater detail below.

### Revenue

GPN installs payment terminals at merchants, such as gas stations or retail stores, so that customers can purchase items using debit or credit cards. GPN receives a small percentage, typically around 0.5%, of each transaction processed. The revenue for GPN is highly predictable due to the nature of the payment processing industry. Each merchant customer signs a three to five year contract for GPN’s services and with more than 1,000,000 merchants in 17 different countries GPN’s revenue is highly predictable.

### Gross Profit

The gross profit for GPN is exceptional. The company benefits from strong operating leverage, meaning that as more terminals are installed the fixed expenses, such as corporate overhead or security solutions, is leveraged across more accounts and gross profit increases. As one of the world's largest merchant acquirers GPN has substantial advantages from economies of scale.

### Owner Earnings

The owner earnings for GPN is the free cash flow available to shareholders after all expenses are paid. The GAAP reported net income typically understates the owner earnings for the business due to the acquisitive nature of GPN's business model. When GPN acquires another business the merchant contracts from the acquired company become GPN clients. These customer relationships are recorded as an 'intangible' assets for GAAP reporting purposes and are amortized over a relatively short time period. In reality these acquired customer relationships last considerably longer than the amortization period. This accounting convention requires a large amortization expense for customer relationships that is overstated and more of a phantom expense – similar to depreciating a rental home. For this reason owner earnings typically are much higher than the reported earnings for GPN.

### Transaction Volume

If a customer at a retail store purchases \$15 using their debit card at a GPN terminal this purchase counts as \$15 in 'Transaction Volume'. As GPN installs more terminals at additional merchants the total transaction volume continues to increase. This in turn increases revenue generated for GPN. The transaction volume continuously increases by adding additional merchants and seeing increased business at existing merchant locations.

### **Historical Performance of Key Metrics**

Year	'09	'10	'11	'12	'13
Total Revenue	\$1,462,306,000	\$1,642,468,000	\$1,859,802,000	\$2,203,847,000	\$2,375,923,000
<i>Gross Profit</i>	\$957,451,000	\$1,057,859,000	\$1,194,785,000	\$1,419,091,000	\$1,513,848,000
Owner Earnings	\$201,665,610	\$214,168,410	\$223,702,830	\$265,570,650	\$256,030,710
YoY Earnings Growth	18.4%	6.2%	4.5%	18.7%	-3.6%
Transaction Volume	\$135,000,000,000	\$146,600,000,000	\$167,300,000,000	\$180,700,000,000	\$192,800,000,000
Cash	\$426,935,000	\$769,946,000	\$1,354,285,000	\$781,275,000	\$680,470,000
Debt	\$209,346,000	\$421,134,000	\$354,019,000	\$312,985,000	\$963,469,000

### Revenue

In the last 10 years revenue has increased every year without exception. The annual average increase in revenue during this time period was 16%. The number of merchants globally adopting electronic payments continues to rise, especially in emerging markets. When a customer's three year contract expires GPN typically signs new three year deals with retention rates in the mid-80% range. This high retention rate coupled with more than 1,000,000 merchants makes GPN's revenue stable. The large sales force continues to add additional merchants each year allowing GPN to continuously increase revenue during difficult global conditions. We fully anticipate GPN to continue to grow revenue at a rate between 3% and 15% per year with an annual average of 8% over the next 10 years.

### Gross Profit

The gross profit, which is profits earned prior to expenses related to the security breach in 2012, have moved lock-in-step with revenue during the last 10 years. The company has compounded gross profits at an average rate of 16% per year and the same global forces benefiting revenue will directly impact gross profits. The expectations for future growth of gross profits are identical to revenue for the next 10 years.

### Owner Earnings

The owner earnings over the last 10 years have grown by more than 400%. The only decrease in owner earnings during this time period was during 2012 / 2013 when the security breach occurred. It is our expectation that when the security breach is squarely behind the company owner earnings will continue to compound at a rate of 3 to 15% annually with a 10 year average of 8%. We also anticipate earnings per share to increase at a faster rate than the overall business due to the capital allocated to share repurchases. Historically approximately 50% of all owner earnings has been allocated to repurchasing shares. The reduced share count increases earnings per share at a rate in excess of the growth of the overall business.

### Transaction Volume

The transaction volume in the last 5 years has grown from \$135 billion in 2009 to nearly \$200 billion in the last twelve months. This represents an annualized growth of 9.3% during the last 5 years. We anticipate this growth rate to continue as GPN signs up additional merchants and existing merchants continue to process more transaction electronically. The increased processing at the merchant level will be driven by two factors: 1) Merchants tend to grow their business over time which benefits GPN, and 2) Penetration rates for electronic transactions continues to rise globally. GPN will benefit as countries around the world continue to shift a higher percentage of all transactions to electronic forms – particularly in emerging markets.

Summary of Key Metrics

<b>Metric</b>	<b>Expectations</b>
Revenue	Growth ranging from 3% to 15% per year Average of 8% over 10 years
Gross Profit	Growth ranging from 3% to 15% per year Average of 8% over 10 years
Owner Earnings	Growth ranging from 3% to 15% per year Average of 8% over 10 years
Transaction Volume	Growth ranging from 3% to 15% per year Average of 8% over 10 years

### **The Moat Around The Metrics**

The payment processing industry is a price competitive industry with little almost no economic moat for any particular business. However, the industry as a whole has been extremely profitable despite the intense pricing competition. The outstanding profitability can be attribute to the characteristics of the industry as a whole. The installation of the terminal is relatively cheap compared to the revenue generated from each location and very few physical assets are required to grow the business. This allows the entire industry to earn high returns on equity.

GPN is able to protect and grow income with great predictability due to the multi-year contracts signed by each merchant. With more than 1,000,000 merchants globally and retention rates in the mid-80% GPN has an extremely stable and fracture customer base. No single merchant contributes uniquely to GPN's income. The sales team at GPN continues to add customers at a rate that is in excess of attrition allowing GPN to continuously

generated additional income. The long-term nature of customer contracts, high retention rates, and outstanding sales team for GPN helps to protect income long into the future.

## **Risks**

We believe that GPN represents a relatively low risk investment due to the predictable nature of the business and highly fractured customer base. However, there are a few risks we have assumed as business owners of GPN.

### Short-Term Risks

- **Cybersecurity Attacks.** As a payment processor GPN is a prime target for cybersecurity attacks. The company was breached in 2012 and has since substantially increased the measures taken to defend against such attacks. There is the possibility that another cyberattack would succeed against GPN. If this were to occur the company would have to allocate additional resources to remediation and increase protection. Every successful security breach impairs GPN's brand and reduces customer's confidence in the company.
  - Moderate Risk
- **Increased Debt.** The company has increased borrowing in recent years for acquisitions and share buybacks. If the company continues to borrow it could potentially jeopardize the company's ability to repay in the event of hardship. We will carefully monitor any future borrowings and would considering selling if the debt burden becomes excessive.
  - Moderate Risk
- **Clearing Services Disruption.** The company utilizes several third party financial institutions for clearing services in connection with settlement activities. In the event that banking partners no longer provide clearing services it would cause a temporary disruption to GPN's service until a new clearing partner is identified. We view this risk as extremely low. The third party financial institutions receive substantial compensation for clearing services and compete intensely to provide these services to merchant acquirers.
  - Low Risk

### Long-Term Risks

- **Visa & MasterCard sponsorship terminated.** The overwhelming majority of all payments are processed through Visa or MasterCard networks. GPN must adhere to the membership rules for these two networks and in the event that the company no longer qualifies for these networks it would materially impact the business. We view this risk as extremely low. Visa and MasterCard work very closely with merchant acquirers, such as GPN, to help with compliance. The business generated by merchant acquirers is integral to the success of Visa and MasterCard.
  - Low Risk
- **Increased Attrition.** The retention rate for contract renewals is extremely important for GPN. If the retention rate were to decline it would have a material impact on the business. The company currently has retention rates in the mid-80% and a decline would greatly hinder future growth. In the event that retention rates fall and no clear path for improvement is laid out we would consider selling the business.
  - Moderate Risk
- **Changes in the regulatory environment.** The payment processing industry has been a hot topic in political debates in recent years. There is the possibility that regulators would change the fees charge by merchant acquirers. In recent years interchange fees where regulatory and maximums enforced that reduced profits for banks around the United States. Unlike bank interchange fees, merchant acquirers compete on price and quality of services. For this reason we view regulatory changes as remote, but not outside the realm of possibility.
  - Low Risk

## **Conclusion**

GPN has posted consistent year-over-year growth for more than 10 years. The company is exceedingly profitable and continues to grow at a healthy pace today. Our opportunity to purchase GPN arose due to a security breach in 2012 and the subsequent remediation fees and increased expenses on security. We believe that the stock price declined too sharply and we were able to purchase our stake in this outstanding business at roughly 11x forward looking earnings. The multi-year contracts combined with high retention rates make GPN one of the most predictable businesses in the US. It is our expectation that GPN will continue to compound earnings at a rate of approximately 8% for the next 10 years.

## **Works Cited**

- 1) *GPN Annual Report - SEC Filing 10-K*. EDGAR, 2013.

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